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India: Foreign Payments Threaten Economic Prospects

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An Intelligence Assessment

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NESA 86-10023
May 1986
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India: Foreign Payments Threaten Economic Prospects [redacted] 25X1

An Intelligence Assessment

This paper was prepared by [redacted] Office of Near Eastern and South Asian Analysis. Comments and queries are welcome and may be directed to the Chief, South Asia Division, NESA [redacted] 25X1

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NESA 86-10023
May 1986

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India: Foreign Payments Threaten Economic Prospects

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Key Judgments

Information available as of 3 March 1986 was used in this report.

A deterioration in India's comfortable international financial position is likely before 1990 because import growth will greatly outpace the growth in exports and the debt service burden and payments for military equipment will increase substantially. The industrial modernization and economic liberalization that Prime Minister Rajiv Gandhi is pushing will increase Indian demand for foreign capital goods and technology.

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New Delhi expects to cope with growing hard currency payments mainly by increasing exports of manufactured goods, but its efforts to ease constraints on production of exportable goods and divert them from the more profitable home market will not be enough to cover the growing foreign payments gap. Moreover, many Indian officials are clearly reluctant to substantially increase commercial borrowing to cover financial shortfalls, and foreign aid is unlikely to grow.

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The government probably will attempt to forestall a payments crisis by reimposing restrictions on imports, even though such a policy reversal would slow domestic economic growth. It would also curb opportunities for US suppliers who are seeking to enter the Indian market.

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India could be spared serious foreign payments problems through the decade, even with a deterioration in its nonoil trade and debt servicing picture, if world oil prices average less than $15 per barrel. Lower world oil prices will help offset a rapid growth in oil import volume resulting from accelerating Indian domestic consumption and a likely decline in domestic production of crude oil.

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Moderate foreign payments strains that would prompt Gandhi to slow or narrow the scope of his liberalization policies would produce little domestic political fallout. Under these circumstances, we would expect economic growth of about 4 percent annually, about the same as the average for the past 20 years but below the 5 percent achieved under the last five-year plan. Some ruling party politicians would even welcome a slowing of liberalization because it would provide a respite from opponents' charges that Gandhi's economic measures benefit the small upper and middle classes and the modern corporate sector at the expense of small businesses and the poor. A severe foreign payments crisis that resulted in sharply reduced growth, however, would almost certainly cause widespread popular dissatisfaction and create significant economic as well as political problems for Gandhi.

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Washington most likely would once again be made the scapegoat for any marked slowdown in Indian economic growth caused by foreign exchange shortages. Indian officials would highlight US import barriers and US policy contributing to a decline in concessional aid. The Soviet Union would reap political and economic benefits. Moscow would tout the advantages for India of bilateral payments arrangements with the USSR that obviate the need for hard currency. 25X1

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Under Prime Minister Rajiv Gandhi, the Indian Government is moving toward the economic strategy adopted by the faster growing less developed countries over the last two decades—increasing exports to spur economic growth. The Indian National Development Council, under Gandhi's chairmanship, approved in November 1985 the long-delayed draft of the Seventh Five-Year Development Plan (1985-89). The plan calls for average annual economic growth of 5 percent, which Indian officials believe is the minimum required to hold down inflation and unemployment. This growth is predicated in large part on a significant increase in external trade, particularly exports.[1] [redacted] 25X1

If exports fall much short of India's expectations, foreign payments strains could jeopardize New Delhi's ability to continue the economic liberalization measures needed to sustain 5-percent economic growth. Such measures include policy changes to encourage imports of capital goods and foreign assistance in modernizing production facilities and developing high-technology industries. Import licensing regulations have been eased, removing restrictions on some industrial machinery and offering a new duty-free import scheme for exporters. New Delhi has promised Indian firms easier access to foreign technology, especially for electronics and export industries, and simplified procedures for employing foreign technicians. The government has even emphasized that foreign equity investment—previously tolerated but not encouraged—will be welcomed in electronics, oil exploration and refining, and fertilizer production. [redacted]

Payments Improvement Since 1980

India's present international financial position is satisfactory. Foreign exchange reserves of about $6 billion are equivalent to five months of merchandise imports compared with less than four months in the early 1980s; the trade deficit of $4.5 billion in FY 1984 (the Indian fiscal year begins on 1 April of the year stated) was about one-third lower than in the early 1980s; and debt service payments of about $2.7 billion were less than 20 percent of foreign earnings in 1984. New Delhi was able to ease import restrictions while coping with the round of world oil price increases in 1979/80—an especially impressive feat when compared with the financial problems encountered by many other LDC oil importers. [redacted] 25X1

Increased crude oil production was responsible for most of the improvement in India's current account balance. Commercial production from the offshore Bombay High oilfield began in 1976 and increased throughout the early 1980s. India began substantial exports of crude oil in FY 1982 because most domestic refineries were not technically equipped to process the light crude; production from onshore fields also increased slightly. As a result, India's net oil import bill in FY 1984 was less than half that in FY 1980. [redacted] 25X1

Funds from Indians who live and work in other countries have also improved India's foreign payments position. Private transfers, which soared to more than $2.5 billion annually in the early 1980s as a result of Indian participation in the Middle East construction boom, have not fallen significantly despite the downturn in the oil-producing countries' economies. Indian press reports indicate that fewer but more highly skilled and better paid workers are obtaining temporary work in the Middle East. According to US Embassy reports, the combined remittances from Indians in the United States and the United Kingdom continue to grow and now exceed transfers from workers in the Middle East. [redacted] 25X1

[1] Economic growth has averaged about 4 percent annually over the past decade, and nonpetroleum exports grew less than 2 percent annually over the past five years. [redacted] 25X1

Table 1
India: Estimated Balance of Payments

Million US $

	1980	1981	1982	1983	1984	1985 [a]	1989 [b]	1989 [c]	1989 [d]
Current account [e]	**−2,740**	**−3,025**	**−2,795**	**−2,770**	**−2,160**	**−3,350**	**−3,120**	**−4,600**	**−3,500**
Trade balance [a]	−7,565	−6,855	−6,000	−5,690	−4,470	−5,690	−5,820	−6,800	−5,000
Petroleum	−6,661	−5,500	−4,565	−3,130	−2,940	−3,100	−4,350	−5,000	−3,000
Nonpetroleum	−904	−1,355	−1,435	−2,560	−1,530	−2,590	−1,470	−1,800	−2,000
Exports (f.o.b.)	8,341	8,660	9,605	9,600	10,560	9,220	11,720	10,200	9,000
Petroleum	11	200	1,235	1,540	1,530	420	0	0	0
Nonpetroleum	8,330	8,460	8,370	8,060	9,030	8,800	11,720	10,200	9,000
Imports (c.i.f.) [e]	15,906	15,315	15,605	15,290	15,030	14,910	17,540	17,000	14,000
Petroleum	6,672	5,700	5,800	4,670	4,470	3,520	4,350	5,000	3,000
Nonpetroleum	9,234	9,815	9,805	10,620	10,560	11,390	13,190	12,000	11,000
Net Invisibles	4,825	3,830	3,205	2,920	2,310	2,340	2,700	2,200	1,500
Private transfers	2,860	2,400	2,620	2,560	2,400	2,400	NA	2,300	2,100
Interest payments [e f]	526	591	948	1,180	1,360	1,500	NA	2,100	2,100
Capital account	**2,435**	**628**	**3,299**	**3,652**	**2,423**	**3,300**	**3,120**	**2,900**	**500**
Principal repayments [e g]	−766	−786	−809	−928	−1,000	−1,200	NA	−2,500	−2,500
Aid disbursements [e]	2,049	1,833	2,211	1,989	1,763	1,950	NA	2,400	2,400
Grants	707	595	560	514	463	450	NA	400	400
Loans	1,342	1,238	1,651	1,475	1,300	1,500	NA	2,000	2,000
Nonconcessional loans [h]	515	858	887	1,378	1,450	1,650	NA	2,000	500
IMF receipts	1,187 [i]	710	1,958	1,365	210	0	NA		
Nonresident deposits	145	179	592	558	610	900	NA	1,000	100
Other including errors and omissions	−695	−2,166	−1,540	−710	−610		NA		
Change in reserves	**−305**	**−2,397**	**504**	**882**	**263**	**−50**			
Financial gap							**0**	**1,700**	**3,000**

Note: Fiscal year beginning 1 April of the year stated. Columns may not add because of categories not shown.

[a] Based on Indian Government projections and CIA estimates.
[b] Seventh Five-Year Plan projection at 1984 prices and 11.8 rupees per US $.
[c] CIA projection of most likely scenario at 1984 prices and 11.8 rupees per US $.
[d] CIA crisis scenario at 1984 prices and 11.8 rupees per US $.
[e] Excluding military. Annual cash and debt service payments for military imports have risen gradually from approximately $600 million in 1980 to about $800 million to $1 billion in 1985.
[f] Including payments to the IMF and on nonresident deposits.
[g] Including IMF repurchases.
[h] Medium- and long-term only, including IBRD.
[i] Including Trust Fund loan and Special Drawing Rights allocation.

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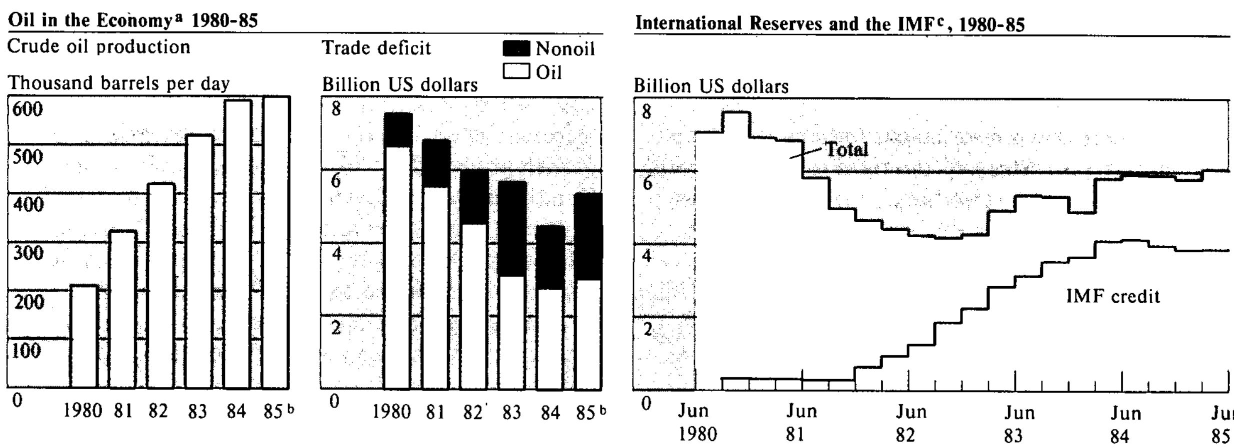
Figure 1
India: Recent Economic Trends



[a] Fiscal year beginning 1 April of the stated year.
[b] Estimated.
[c] End of period.

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These favorable developments have allowed India to reduce its current account deficit despite higher foreign exchange expenditures on petroleum exploration and development, other imports, and rising debt service payments. Increased imports of capital goods reflect the cautious easing of import restrictions begun in the late 1970s. A sharp increase in fertilizer consumption during the last two years, combined with problems in domestic fertilizer production, also led to a substantial increase in imports, as did efforts to ensure adequate supplies of high-priced edible oils during the months preceding the 1984 national election.

Financing the Gap

A large credit from the International Monetary Fund (IMF) negotiated in 1981, shortly after India's oil import bill mounted to 80 percent of merchandise export earnings, was critical in helping stave off foreign payments problems. Without the $4.2 billion drawn over the past five years, New Delhi would probably have imposed additional import restrictions. 25X1

New Delhi also tempered its "historical" reluctance to borrow from international money markets. During the past five years, the government has authorized commercial borrowings of $7.4 billion for private- and public-sector projects.[2] Disbursements of these commercial loans are accelerating and reached about $1.2 billion in FY 1984. Indian commercial borrowing has reached about 45 percent of total loans and grants obtained from foreign sources. 25X1 25X1

[2] This figure excludes borrowing over the past five years of an average of $320 million annually on commercial terms from the International Bank for Reconstruction and Development (IBRD). 25X1

Foreign aid continues to provide a major supplement to India's foreign exchange earnings. Reporting from international financial institutions indicates that new financing probably exceeded $2 billion in FY 1984. Total commitments of grants, concessional loans, and IBRD loans, however, are at about the same level as the early 1980s. [redacted]

Bank deposits from nonresident Indians—attracted by high interest rates and the right to convert funds into hard currency—also have provided significant capital flows into India during the past few years. They contributed about $600 million in foreign currency in FY 1984 and helped India add over $1 billion to its foreign exchange revenue since 1981. [redacted]

Increasing Strains Likely

Modernization, deemed necessary by the government to achieve growth targets, combined with scheduled repayments to the IMF and suppliers of military equipment is likely to reverse the favorable foreign payments trend of the last few years. The Finance Minister has publicly warned of an "impending foreign exchange crunch," and official Indian analyses describe the medium-term outlook as "not easy" or "uncomfortable." Preliminary statistics for FY 1985 indicate a deterioration in the payments balance has already begun. [redacted]

Import Outlook

The government is planning on an average annual growth in imports of 5.8 percent from FY 1984 to FY 1990 to support its economic growth target, but we believe this rate could easily be exceeded. Preliminary government reports indicate nonoil imports in FY 1985 were about 8 percent greater than in FY 1984. Although some of this growth can be attributed to greater-than-necessary imports of commodities earlier in the fiscal year, the pent-up demand for imports of consumer items and high-quality capital goods will be hard to contain unless some economic liberalization measures are curtailed. [redacted]

Along with modernization, the accelerated industrial growth that Gandhi seeks will generate increased demand for imported capital goods and technology. Imports for capital improvements will be needed particularly to ease electricity and telecommunications shortages, as well as to satisfy Gandhi's emphasis on the development of electronics and computers and further the expansion of motor vehicle production. [redacted] 25X1 25X1

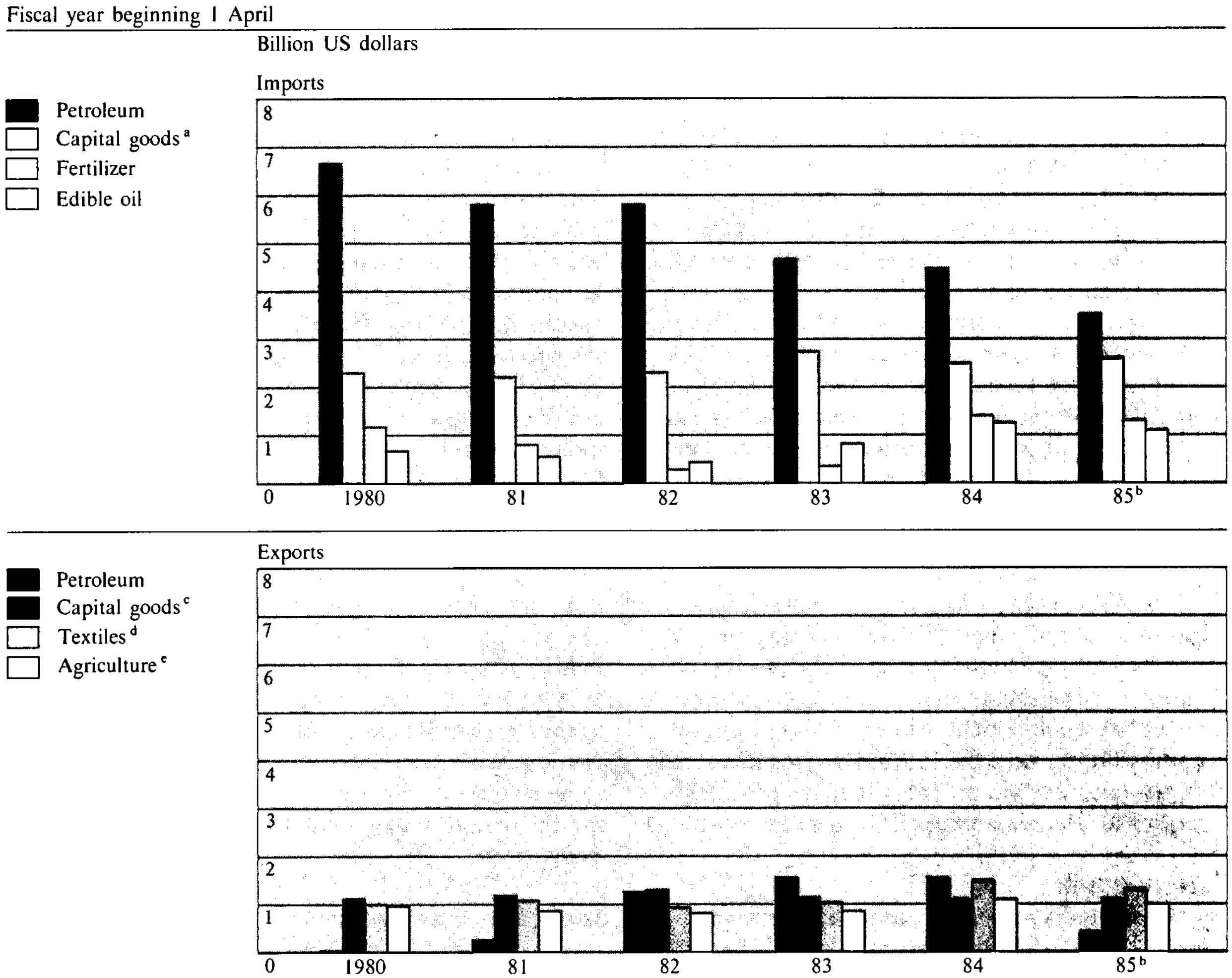
The volume of petroleum imports is almost certain to increase faster than the 8-percent average annual growth projected by the government, particularly as Gandhi pushes for faster industrial growth and domestic oil production declines. Demand for petroleum products could grow by 7 percent a year, according to our analysis of recent trends, slightly above the government projection of 6.4 percent. Liberalization measures are making more automobiles available, many manufacturers are using diesel generators to maintain production when electricity from the public grid fails, and many farmers have turned to diesel pumps for irrigation. [redacted] 25X1 25X1

[redacted] offshore crude production may have leveled off, or even begun to fall, and that onshore production will begin to decline within the next five years—perhaps this year.[3] The study indicates crude oil production will decline to 500,000 barrels per day (b/d) in FY 1989 compared with about 600,000 b/d in FY 1985. The government plan calls for production of 700,000 b/d in FY 1989, but the low end of new government estimates projects output close to current levels. No major commercially viable deposits have been confirmed since the Bombay High oilfield was identified in 1966. [redacted] 25X1 25X1 25X1

On the basis of projections of India's crude oil demand of 1.2 million b/d, we estimate that its net oil import bill, at an average sustained price of $20 per barrel, will be $5 billion in 1989. The government

[redacted] 25X1 25X1 25X1

Figure 2
India: Commodity Composition of Trade



[a] Machinery and transport equipment.
[b] Estimated.
[c] Manufactured metal products.
[d] Garments and cotton fabrics only.
[e] Coffee, tea, and tobacco only.

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projected a $4.4 billion oil import bill for 1989, using $30 per barrel—the average cost of oil imports in FY 1984. A sustained world oil price of $10 to $15 per barrel over the next four years would hold the net oil import bill to $2.6-3.8 billion—about the same as the average for the past three years. [redacted]

Import substitution remains a major theme of India's foreign trade policy, but we expect only small gains during the current plan. The emphasis on development of indigenous high-technology industries—particularly in electronics and oil exploration equipment—could even risk encouraging a new generation of uncompetitive manufacturing sectors with minimal net foreign exchange savings. According to US agricultural officials, the push to curb imports of edible oils through increased oilseed production could lead to some foreign exchange savings within a few years. A marked impact is not likely before the end of the decade, however, because of growing domestic demand. [redacted]

Increased production of natural gas from the giant Bassein offshore field will eventually lower India's nitrogen fertilizer import bill, but poor gas quality, along with delays in issuing tenders for pipeline construction and the diversion of drilling resources to the Bombay High oilfield, will delay significant import substitution until the 1990s. Growing demand for nitrogen fertilizer will probably outpace production increases for the remainder of this decade. [redacted]

Export Outlook

We believe India's five-year target of 6.8-percent average annual growth in export volume, although lower than originally projected, is too optimistic and that India will be lucky to achieve 3-percent annual growth. During the past five years, the volume of nonpetroleum exports grew less than an average 2 percent a year, according to IBRD and IMF estimates, and preliminary government statistics indicate nonoil exports declined slightly in FY 1985. [redacted]

Indian officials look primarily to a sharp increase in the volume of exports, particularly manufactured goods, to generate economic growth and keep foreign payments strains manageable. New Delhi has indicated that it expects to boost exports of manufactured goods by about 8 percent annually and maintain adequate supplies in the domestic market primarily by improving overall industrial efficiency. Gandhi expects productivity gains from cooperation with foreign firms, greater competition within India, and reduced bureaucratic interference. He has stated publicly that he wants India to overcome technological obsolescence, which has contributed to the high cost and low quality of much Indian production. [redacted] 25X1 25X1

The government plan projects agricultural exports to grow by only 3 percent annually. India currently enjoys surpluses but has inadequate storage, and it is struggling to find markets for its wheat.[4] Indian press reports indicate that New Delhi is trying to arrange a long-term agreement for wheat purchases by the Soviet Union, but sales will depend on continuing surpluses, improved port and handling facilities, and quality control. In addition, we believe there is potential for increased exports of cotton and processed food. [redacted] 25X1

New Delhi, however, continues to regard agriculture as a tool to alleviate poverty by providing more food and jobs and as a key supplier of raw materials for the industrial sector. Thus, we have seen no indication that New Delhi will modify its refusal to risk shortages or higher domestic prices to increase agricultural exports. We believe increased domestic demand for some traditional exports such as tea, coffee, and marine products may limit future exports of these items. [redacted] 25X1 25X1 25X1

In our view, a major obstacle to increasing productivity and output of exportable goods is the electricity shortage, which amounted to about 11 percent of estimated demand in FY 1984, according to government statistics. Under the new five-year plan, the government hopes to increase the growth rate of power generation by more than 12 percent annually 25X1

[redacted] 25X1

by concentrating financial resources on projects already under way and improving the low rate of efficiency—less than 50 percent in 1984, compared with a developed-country industry norm of 65 to 70 percent—at India's operational thermal power plants. [redacted]

We doubt, however, that the government can meet the new electrical generating target. It missed an even lower target in the last plan by almost 30 percent, and the insufficient distribution and transmission network, poor equipment and maintenance, low electricity prices, and poor management make a quick turnaround unlikely. The industry also must contend with the declining quality of domestic coal and possible shortages of coal caused by the government's inability to reach the planned output target. [redacted]

We also doubt that New Delhi has developed a detailed strategy to ensure that increased production of manufactured goods, if achieved, will lead to faster growth in exports. In the past, sales to the domestic market have often been more profitable than exports. Indian press reports suggest that government hopes are highest for increased exports of manufactured engineering goods, chemicals and related products, automobile components, and garments. [redacted]

The Indians have not always been receptive to recommendations on how best to promote exports. The IBRD and IMF advised India to devalue the rupee more rapidly, but Indian officials instead hope to increase the competitiveness of exports by limiting domestic inflation. The IBRD also urged New Delhi to increase financial incentives for exports that are already in place, including cash payments, tax refunds, and income tax concessions, because the current benefits do not fully compensate for the high domestic tax burden. The government has not yet agreed to implement these suggestions. [redacted]

We do not expect the world trading environment to be an insuperable obstacle to faster export growth. IBRD analysts contend that India is doing so poorly in the world market that it has wide scope for gains from revised domestic policies. New Delhi has complained vociferously about protective trade policies in developed countries, which limit a few Indian exports, such as some categories of garments, in an attempt to open more markets. It is also turning increasingly—albeit reluctantly and on a small scale—to barter to cope with the financial problems of its LDC trading partners. [redacted] 25X1

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Other Opportunities for Payments Relief

New Delhi hopes to supplement its merchandise export earnings with increased sales of services. Development of software for export is receiving particular emphasis—a reflection of Rajiv Gandhi's interest in computers and New Delhi's belief that India's scientific skills and low labor costs give it a comparative advantage in this field. New Delhi is also pushing sales of consultancy and management services for 25X1 industrial projects and hotels, even though many of its principal customers in Africa and the Middle East have become strapped for funds. In addition, Gandhi has increased the budget for promotion of tourism, although he expects the private sector to finance most expansion of luxury hotels. We believe that results will not come quickly. At best, expanding service exports would net only an additional $400-500 million a year in foreign exchange by the end of the decade. 25X1

[redacted] 25X1

We believe that an increase in foreign grants and concessional loans to India is unlikely, as donor countries try to curb expenditures and China and Africa absorb an increasing share of International Development Association (IDA) resources. Aid disbursements to India over the next three years or so will probably be about the same as commitments made in the past. Moreover, the terms of financial support available from bilateral donors and multilateral lending institutions have already begun to harden. IBRD support is shifting from highly concessional IDA credits to IBRD loans, which offer only slightly 25X1 cheaper interest rates—though longer maturities—than India can obtain on commercial money markets.

[redacted] 25X1

[redacted] 25X1

Indian officials are not seeking direct foreign investment as an important source of funds to relieve foreign payments strains, even though Gandhi has eased bureaucratic impediments to the transfer of technology from foreign businesses. India historically has sought economic self-sufficiency, in part because it feared domination by foreign companies and the competition posed by large multinational firms. Strong domestic growth, however, could attract capital from nonresident Indians, some of whom have already attempted to take over major Indian corporations. It could also prompt Indian firms to repatriate funds they are holding abroad illegally. [redacted] 25X1

Debt Service and Commercial Borrowing

India's debt service burden will escalate over the next five years as obligations to the IMF and commercial bankers add to the substantial amount due on aid received over the past 30 years. The IBRD estimates that debt service could reach $5.6 billion by FY 1989, or roughly 25 percent of current receipts, even if export earnings rise sharply and concessional aid increases modestly. On the basis of IMF information, we estimate that debt service outflows were about $2.7 billion in FY 1985. (Although published Indian projections anticipate principal and interest payments peaking in FY 1989 at $3.2 billion, these projections exclude military payments and loans now being negotiated or likely to be negotiated within the next two years.[6] They may also exclude debt service on loans already arranged but not yet disbursed.) [redacted] 25X1

The IBRD debt service estimate assumes that New Delhi borrows on commercial terms to finance imports needed to sustain a 5-percent growth in GDP. The IBRD has estimated that India would need to borrow an average of $3.6 billion annually to meet its growth target. Changes in world interest rates would modify these projections, but only slightly—less than $50 million for each percentage point variation. Much of India's debt, moreover, consists of fixed-interest loans. [redacted] 25X1

[6] Excluding nonconcessional IBRD loans. [redacted] 25X1

Paying for Military Equipment

Payments for purchases of military equipment are already beginning to reflect the expansion and modernization of the Indian armed forces begun by Indira Gandhi and continuing under Rajiv. Orders placed since 1980 are worth some $10 billion, according to US Government estimates. Despite highly concessional financing by the Soviet Union, India's main supplier, we estimate—on the basis of past sales and current negotiations—that cash payments and debt service on military deals will increase gradually from about $800 million in 1985 to roughly $1.6 billion by 1990. About $1.1 billion will be owed to the Soviet Union in 1990 and about $500 million to Western Europe, primarily France and Great Britain. Trade and debt service estimates published by the Indian Government or multilateral financial institutions do not reflect military expenditures, which are apparently classified for national security reasons. [redacted] 25X1

Although receipts from commercial borrowing are likely to increase during the next five years—India enjoys a high credit rating among lenders—they probably will remain below the level suggested by the IBRD, largely because Indian bureaucrats will remain leery of falling into a debt trap. India's commercial borrowing has averaged only $1.2 billion annually since 1980, and Finance Minister V. P. Singh said early this year that India would borrow no more than $2 billion a year abroad over the next few years. Some government officials have recommended a clampdown on imports if debt service payments seem likely to exceed 20 percent of current receipts. Only Ram Malhotra, the head of India's Central Bank, has shown any flexibility, indicating to US officials that a 25-percent ratio might be acceptable. We believe that even he would reject IBRD advice to speed overall growth by accepting commercial loans for general imports as well as for projects. [redacted] 25X1

The government already is looking at measures to cope with the rising debt service burden. New Delhi will probably supplement disbursements from loans already negotiated by seeking new commitments that need not be amortized before 1990, when repayment obligations to the IMF will have been met. It is also trying to diversify borrowing by tapping yen and long-term sterling bond markets. [redacted]

Payments Scenarios

In summary, growing hard currency outflows over the next five years for imports and debt service are not likely to be offset by an increase in exports or capital inflows from noncommercial sources. Nevertheless, New Delhi's conservative approach to foreign borrowing makes it unlikely that India will have a debt crisis like that in Latin America or will need to reschedule its debts. We believe Gandhi is likely to cope with forthcoming financial strains by modifying domestic economic policies. [redacted]

We present three possible payments scenarios and the likely Indian Government policy response to each. The scenarios are presented in descending order of probability. [redacted]

IBRD Model of Forthcoming Strains

The International Bank for Reconstruction and Development (IBRD) has developed a model that explores the impact of growth in India's economy on its balance-of-payments position. This model specifies assumptions about the relation between import requirements and GDP or industrial growth and about world prices, world market growth, and interest rates. It generates scenarios in which high domestic growth is feasible if India's exports grow substantially faster than has been the historical trend. Other scenarios lead to an unmanageable debt service burden within the next 10 years if high domestic growth rates are combined with slow export growth. [redacted] 25X1 25X1

A major assumption on oil incorporated in the IBRD model is unduly optimistic, in our judgment, even apart from prospects for very rapid export growth. The IBRD model assumes that domestic crude oil production will grow 5 percent a year. [redacted] *little or no growth is more likely. Other optimistic, though plausible, assumptions call for improvement in India's terms of trade and an increase in at least the nominal value of aid receipts, private transfers, and nonresident deposits.* [redacted] 25X1 25X1 25X1 25X1

Renewed Import Restraint and Lower Growth

The most likely scenario, in our judgment, would put India's overall economic growth at about the 3.8-percent annual average rate that has prevailed since the mid-1960s, exports would grow by about 3 percent, and the current account deficit would exceed $4.5 billion. Projected capital receipts would cover only about two-thirds of the payments deficit, leaving a financial gap of about $1.7 billion. Commercial bankers would harden their lending terms as they became aware of the country's growing petroleum and military payments burden. India would have to dip into foreign revenues to pay its bills. This scenario would correspond in many—but not all—respects to the slower domestic growth scenario in the IBRD model. [redacted]

Rather than risk a large debt servicing burden under such circumstances, we believe Gandhi would sacrifice some import liberalization. We believe New Delhi would initially try to meet demands for petroleum, fertilizer, and grain, and to preserve access to foreign technology for industrial electronics and for export industries. We believe, however, that Gandhi would pull back on plans to spur domestic efficiency through increased import competition and might close off recently introduced opportunities for import-intensive production of vehicles and consumer durables. [redacted] 25X1

Gandhi's current emphasis on simplifying bureaucratic procedures suggests that he would emphasize tariffs rather than discretionary import licenses to slow import growth. The administrative structure for tighter licensing controls remains in place, however, and he probably would also take some steps in that 25X1

Table 2
India: Balance-of-Payments Scenarios
Prepared by the IBRD

	Optimistic	Unmanageable	Slower Domestic Growth	Comments
	Percent			
Gross domestic product growth [a]	5.0	5.0	4.0	GNP growth trend in 1970s was 3.6 percent a year; so far in 1980s, 4.8 a year.
Export volume growth [a]	8.1	6.1	6.1	Volume of nonpetroleum exports grew 7.3 percent a year in 1970s; probably less than 2 percent a year so far in 1980s. High-growth scenarios assume increasing Indian share of world markets.
Import volume growth [a]	6.4	6.3	4.5	High-growth scenarios assume imports of edible oils and grain fall and industrial imports merely keep pace with industrial growth.
Net petroleum import volume growth [a]	11.0	11.0	NS [b]	Assumes 5-percent annual growth in domestic crude production.
Debt service in FY 1989	21.6	25.3	22.4	Does not include servicing of military debt.
	Billion US $			
Merchandise trade deficit in FY 1989	9.2	NS	NS	Results sensitive to assumptions about world prices.
Net commercial borrowing in FY 1989	4.1	5.2	3.3	Assumes commercial borrowing increases sufficiently to meet import requirements.

[a] Annual average for FY 1985 through FY 1989.
[b] Not Specified.

Source: International Bank for Reconstruction and Development.

[redacted] 25X1

direction. The fiscal policy announced in December contains provisions that could be used to restrict imports, and the budget announced in late February added some restrictions to imports of capital goods. [redacted]

The government could limit the negative impact of new import restrictions on overall growth by relaxing government restrictions on investments and production and following through on tax reform. The potential benefits of liberalized domestic policies cannot be realized, however, unless Indian manufacturers can turn to foreign suppliers when domestic inputs are inferior or not readily available. [redacted]

Avoiding Serious Problems

We cannot rule out a combination of favorable circumstances and policy changes that would enable India to avoid foreign payments constraints on overall growth. At a minimum, this would require sustained world petroleum prices of less than $15 per barrel, annual oil-consumption growth held to 6 percent or less, domestic oil production at the 1986 level or higher, few additional quota barriers to exports such as garments, increased export incentives, favorable weather patterns in India, and efficient operation of thermal power plants to minimize constraints on

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production of exportable goods. Under these circumstances, we would envisage a current account deficit of about $3 billion and economic growth of about 5 percent. This scenario is similar to India's five-year plan, except that exports would not reach targeted levels. [redacted]

On the policy side, the introduction of more comprehensive tax rebates could induce Indian businessmen to intensify their search for foreign markets and exploit links to the growing number of educated Indians who work abroad. New Delhi will have to maintain or increase real domestic oil prices to hold down the growth in consumption. If the international trading environment looks favorable, Gandhi might push Indian financial officials to accept the risk of a significant increase in commercial borrowing, counting on import substitution or a new IMF loan to ease the payments burden in the early 1990s. Opening the domestic economy to more foreign investment would be critical to relieving some of the strains on foreign exchange without resorting to commercial borrowing. [redacted]

A Crisis Scenario

Possible sources of greater financial strains that would require the abandonment of the liberalization program include successive monsoon failures resulting in large food imports; economic disruption caused by a marked increase in political instability, perhaps triggered by the assassination of Rajiv Gandhi; and a slowdown in world economic growth combined with deterioration in India's terms of trade. Stagnant economic growth and exports would force India to cut nonessential imports drastically to pay for food imports. New Delhi, however, would still be faced with a current account deficit of $3 billion and a financial gap of over $2 billion. It probably could not meet its debt service obligations to the IBRD, IMF, and commercial banks and would be forced to undertake even greater austerity measures. [redacted]

The Political Fallout From Foreign Payments Strains

Gandhi's economic programs have strong appeal for much of India's large, modern corporate sector, but a squeeze prompting him to slow some of his controversial liberalization policies would, on balance, probably bring him modest political gains. Although some of Gandhi's critics would cite a retrenchment as evidence that his economic measures were ill conceived, such a shift could also stem mounting criticism that he is slighting the poor in favor of India's small upper and middle classes and its private corporate sector. Government statistics indicate that less than 3 percent of the population has sufficient income to benefit from Gandhi's large tax cuts on personal income, wealth, and inheritances. Some Indians, including members of his own party, fear that Gandhi, in his enthusiasm for "middle-class" issues, may allow welfare and rural programs to stagnate and, in his quest for efficiency, cut jobs in India's state-owned industries. Moreover, some long-established industrialists would welcome a reprieve from the loss of protection and heightened foreign competition brought on by Gandhi's reforms. 25X1
[redacted] 25X1

Rajiv and Indian Socialism

Socialism in the Indian context signifies a philosophic and economic orientation. In practice, it implies government control of key industries, an emphasis on national self-sufficiency, and a commitment to improve the lot of the poor. [redacted] 25X1 25X1

Despite its vagueness, the Indian version of socialism has been cherished in the Congress Party since its British-educated leaders secured national independence. Even Gandhi—who, unlike his grandfather's or mother's generation, favors the private sector as an important contributer to economic modernization—has found it expedient to maintain the rhetoric of socialism in deference to party "conservatives." After veteran Congress Party politicians criticized him last spring for slighting the principles of the founding fathers, Gandhi reiterated his commitment to "socialism" in a speech at the celebration of the Congress Party centenary in May 1985. [redacted] 25X1 25X1

A change in the pace or scope of liberalization would entail no fundamental redirection of the economy. The liberalization program, although notable in the Indian context, has been cautious, retaining key elements of Indian economic policy—including an emphasis on achieving self-reliance and the government's control of the direction of the economy. [redacted]

Any Indian government—including Gandhi's—would face widespread popular dissatisfaction in the unlikely event of a foreign payments crisis that leads to a sharp decline in growth. We believe a prolonged recession would result in heightened social unrest and political protest. Such extreme conditions could spur India's fragmented opposition to press for a new election and challenge the incumbent Congress Party at the polls. [redacted]

Implications for the United States

Opportunities for US suppliers will be reduced if, as we expect, Indian exports do not grow fast enough to ease the burden of growing petroleum imports, military equipment purchases, and debt service payments. In addition to the impact of import restrictions, slower Indian growth would also reduce demand for imports. Purchasing decisions by Indian Government agencies would give greater weight to price and financial terms, even in high-technology areas, in some cases providing an advantage for Japanese or European suppliers. US exporters with established ties to Indian firms would suffer less than newcomers, since New Delhi usually considers import history when allotting licenses to Indian businessmen. [redacted]

The United States could also face some diplomatic fallout from a marked slowdown in Indian economic growth that is associated in India with foreign exchange shortages. Some Indian officials already see an anti-Indian bias in US policies that limit Indian access to IDA and Asian Development Bank loans. Although declining aid receipts, in our judgment, will not be the major cause of the foreign payments problems India will face during the next five years, New Delhi is concerned about such cutbacks and about restrictive trade policies in industrial countries. We believe complaints about US policies will escalate as problems mount and advocates of liberalized economic policies seek a scapegoat for failure to improve economic performance. [redacted] 25X1

The Soviet Union would reap political and economic benefits from a deterioration in India's payments situation. New Delhi's dependence on the Soviet market for its manufactured goods would increase if sales to hard currency buyers falter, and Moscow would undoubtedly stress the benefits of bilateral agreements that obviate need for payment in hard currency. Moscow already serves as a market for 13 percent of India's exports, and an Indian journalist has recently written a book showing the dependence of several Indian industries on the Soviet market for their continued viability. [redacted] 25X1

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Economic Ties to the Soviet Union

Economic ties to the Soviet Union will affect India's hard currency foreign payments position even though all payments to Moscow for imports, exports, and debt service are made through a clearing account and neither require nor earn hard currency. [redacted] 25X1 25X1

To avoid large or persistent payment imbalances, the two governments negotiate quantity or value targets for commodity trade annually as well as in five-year trade agreements. The published targets exclude Indian purchases of military equipment but usually provide for an Indian trade surplus to cover debt service on military and economic aid. In the past, the planned surplus has been small. The arrangement has benefited India because it has obliged Moscow to buy enough Indian goods, including low-quality products that have few other markets, to offset Indian purchases of essential items—mostly petroleum in recent years. [redacted] 25X1 25X1

[redacted] 25X1